Supreme Court, U.S.
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No. 95-1581

In The

Supreme Court of the United States

October Term, 1995

MARION HURINENKO, *et al.*,

Petitioners,

vs.

CHEVRON U.S.A., INC., *et al.*,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the District Court for the District of North Dakota and the Eighth Circuit Court of Appeals correctly applied North Dakota law in determining that, for purposes of payment of royalties, the "market value at the well" of gas can be determined by deducting processing costs from the gross proceeds received for the sale of gas and other products at the tailgate of the processing plant?

PARTIES TO THE PROCEEDING

Pursuant to Rule 29(6) of the Supreme Court Rules, the Respondents and, where applicable, their parent corporations and nonwholly owned subsidiaries are as follows:

Chevron U.S.A., Inc., Warren Petroleum Co., and their parent corporation, Chevron Corp.

The William Herbert Hunt Trust Estate, whose trustee is J.W. Beavers, Jr.

Petro Hunt Corporation

TOC-Rocky Mountains, Inc., Amoco Production Company, and their parent corporation, Amoco Corporation

MW Petroleum Corporation and its parent corporation, Apache Corporation

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STATEMENT OF THE CASE

This action involves the interpretation of, and payment of gas royalties under, a 1972 oil and gas lease covering lands in North Dakota. The gas in question is produced together with oil from a number of wells, and is taken from the various wells to a central processing plant where hydrogen sulfide and various liquid hydrocarbons are removed from the raw gas stream. Sulfur, various liquid hydrocarbons such as propane, and "residue" or "dry" gas are then sold at the tailgate of the plant. (Pet., p. 2b). The Respondents are working interest owners, or lessees, under the oil and gas lease in question and are also owners of the gas processing plant. Under the oil and gas lease, the Petitioners, who are mineral owners, or lessors, are entitled to royalties of one-eighth of the "market value at the well" of the gas.[1] (Pet., p. 4a).

Since 1978, when production first began under the lease, the Petitioners have been paid royalty in accordance with what has been described as the "work-back method" — that is, gross proceeds at the tailgate of the plant less the costs of gathering, treating and processing the gas. (Pet., p. 3a). In 1993, after accepting royalties calculated in accordance with this method for 15 years, the Petitioners commenced this action, asserting that they should have been paid royalties on the gross value at the tailgate of the plant. (Pet., p. 4a). Petitioners seek to be paid not on the "market value at the well," but on the "market value at the tailgate of the plant," after value has been added by gathering, treating and processing.

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1. The Petitioners previously asserted that they were entitled to royalty based on one-eighth of the "proceeds from the sale of the gas" under a provision of the royalty clause applicable to gas "from wells where gas only is found." The district court rejected this contention (Pet., p. 9b), as did the court of appeals (Pet., p. 4a). The Petitioners have apparently abandoned this claim.

This action was commenced in state district court, then removed to the District Court for the District of North Dakota on the basis of diversity jurisdiction under 28 U.S.C. § 1332. The district court granted summary judgment dismissing the petitioners' complaint. On appeal, the court of appeals affirmed the action of the trial court. Petitioners have now filed a petition for writ of certiorari under 28 U.S.C. § 1254(1).

REASONS FOR DENYING THE WRIT

I.

BOTH THE DISTRICT COURT AND THE APPELLATE COURT PROPERLY APPLIED NORTH DAKOTA LAW TO THE DISPUTE INVOLVING THE INTERPRETATION OF A CONTRACT RELATING TO REAL PROPERTY LOCATED IN THE STATE OF NORTH DAKOTA.

In their effort to obtain review before this Court, the petitioners have mischaracterized the status of North Dakota law relating to the deduction of processing costs in determining "market value at the well." Petitioners assert that the "thrust" of *West v. Alpar Resources, Inc.*, 298 N.W. 2d 484 (N.D. 1980), is that "when a lease does not state otherwise lessors are entitled to royalty payments based on a percentage of total proceeds received by the lessee, without deduction for costs." (Pet., p. 5).

In *West*, the applicable lease provision required the payment of royalty not on the basis of "market value at the well," but on the basis of "the proceeds from the sale of gas, as such." 298 N.W. 2d at 486. The North Dakota court reviewed cases from various jurisdictions holding that royalty payments were subject to a variety of deductions and cases from other jurisdictions determining that such deductions may not be made. Contrary to

the assertion of the petitioners that the court in *West* "aligned itself with Kansas, Colorado, Oklahoma and Arkansas [by] applying the implied covenant of marketability" (Pet., p. 6), the North Dakota court expressly declined to decide the issue, stating as follows:

> Although the foregoing authorities provide background and helpful insight, we must ultimately decide this case upon the express language of the lease using appropriate rules for interpreting contractual agreements.

Id., at 490.

The court then determined that the term "proceeds" was ambiguous because rational arguments can be made both in support of the view that the term means "gross proceeds" and the view that the term means "net proceeds." *Id.* Noting that an ambiguous oil and gas lease should be construed against the lessee, the North Dakota court said as follows:

> We do not believe it is necessary in the instant case to attempt to determine whether expenses relating to the extraction of hydrogen sulfide or other expenses incurred by Alpar in marketing the gas fall within the category of "production expenses" or "processing expenses." Nor do we find it appropriate to determine whether or not the lease impliedly placed the royalty obligation at the well head rather than at the point of sale. Consistent with our view that the lease must be construed most strongly against Alpar, we conclude that the Wests are entitled to royalty payments based upon a percentage

> of the total proceeds received by Alpar from the sale of the gas without deduction for the cost of extracting hydrogen sulfide and without deduction for any other costs incurred by Alpar.

Id. at 491.

Some seven years after deciding *West*, the North Dakota Supreme Court addressed the issue of the determination of "gross value at the well" for purposes of North Dakota's gross production tax on oil and gas. In *Amerada Hess Corp. v. Conrad*, 410 N.W. 2d 124 (N.D. 1987), the North Dakota court affirmed the use of a "work-back" method, under which the costs of transportation, processing and treatment are deducted from the ultimate proceeds of sale, in order to determine "gross value at the well." The North Dakota court noted that the phrase "gross value at the well" was stipulated by the parties to mean the "fair market value of the gas." 410 N.W. 2d at 128. In determining that the work-back method was an appropriate method of valuation, the court relied, in part, upon *Piney Woods Country Life School v. Shell Oil Company*, 726 F.2d 225, 233 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005, 105 S. Ct. 1868, 85 L. Ed. 2d 161 (1985). 410 N.W. 2d at p. 129.

In *Piney Woods*, the Fifth Circuit Court of Appeals, applying Mississippi law, stated as follows:

> We agree with Shell that the specification in the leases that the royalty is computed "at the well" controls. In Part III of this opinion, we discuss the purposes of distinctions between "amount realized" and "market value at the well." We concluded that "at the well" refers not only to the place of sale but also to the

> condition of the gas when sold. "At the well" means that the gas has not been increased in value by processing or transportation. It has this meaning in conjunction with "value" or "amount realized" as well as with "sold." The lessors under these leases are therefore entitled to royalty based on the value or price of unprocessed, untransported gas. On royalties "at the well," therefore, the lessors may be charged with processing costs, by which we mean all expenses subsequent to production, relating to the processing, transportation, and marketing of gas and sulfur.

726 F.2d at 240 (citations omitted).

Thus, *West* does not hold that "when a lease does not state otherwise lessors are entitled to royalty payments based on a percentage of total proceeds received by the lessee, without deduction for costs." (Pet., p. 5). It holds only that when royalties are payable on the basis of a "proceeds" royalty clause, with nothing to indicate whether such proceeds are "net" or "gross", no deduction may be made from the proceeds received by the producer, or lessee, for the cost of extracting hydrogen sulfide.

Instead, the North Dakota court, when determining the "gross value at the well" of gas, which it accepted as meaning the fair market value of the gas, specifically relied on the work-back method approved in *Piney Woods*. *Amerada Hess*, *supra*. Under that method, when royalties are payable "at the well", lessors may be charged with processing costs, meaning all expenses subsequent to production, relating to the processing, transportation, and marketing of gas and sulfur.

The district court properly applied this North Dakota law. It noted that the petitioners, in attempting to rely on *West*, chose "to ignore the fact that the operative language in *West* was "1/8th of the proceeds from the sale of the gas" as opposed to "1/8th of the market value at the well" in the instant case. (Pet., p. 5b). It then said:

> Common sense requires that market value at the well be computed by adding the proceeds from the sale of gas at the plant tailgate and the proceeds from sale of by-products, and from that total deducting some commercially reasonable computation of the costs of putting the product in a sellable form.

(Pet., p. 9b).

The court of appeals similarly distinguished the "proceeds" royalty clause of *West* from the "market value at the well" clause in this case and recognized the North Dakota Supreme Court's adoption of the "work-back" method. (Pet., p. 5a).

II.

NEITHER THE DISTRICT COURT FOR THE DISTRICT OF NORTH DAKOTA NOR THE EIGHTH CIRCUIT COURT OF APPEALS ERRED IN FAILING TO CERTIFY ANY QUESTION TO THE NORTH DAKOTA SUPREME COURT.

Petitioners imply that the district court, and perhaps the Eighth Circuit Court, should have certified a question to the North Dakota Supreme Court.[2]

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2. Petitioners do not even attempt to explain the apparent inconsistency

(Cont'd)

The North Dakota Supreme Court has adopted, as Rule 47 of the North Dakota Rules of Appellate Procedure, the Uniform Certification of Questions of Law Act, which provides that the Supreme Court may answer questions of law certified to it by the Supreme Court of the United States, a Court of Appeals of the United States, the United States District Court, or the highest appellate court or an intermediate appellate court of any other state "if there are involved in any proceeding before it questions of law of this state which may be determinative of the cause then pending in the certifying court and as to which it appears to the certifying court there is no controlling precedent in the decisions of the Supreme Court of this state." Rule 47(a), North Dakota Rules of Appellate Procedure. The rule may be invoked either upon a court's own motion or upon the motion of any party to the cause. Rule 47(b), North Dakota Rules of Appellate Procedure.

This Court has indicated its reluctance to substitute its judgment for that of the district court or the court of appeals on matters of certification:

> We do not suggest that where there is doubt as to local law and where the certification procedure is available, resort to it as obligatory. . . . Its use in a given case rests in the sound discretion of the federal court.

Lehman Brothers v. Schein, 416 U.S. 386, 390-391, 94 S. Ct. 1741, 40 L. Ed. 2d 215 (1974).

There are several reasons why certification of any question is not required in this case.

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between this argument and their argument that *West* is controlling in this case. Indeed, in suggesting that a question should have been certified, the Petitioners acknowledge the inapplicability of *West v. Alpar Resources, Inc.* to this case.

First, North Dakota law is not particularly doubtful. By its own terms, Rule 47 of the North Dakota Rules of Appellate Procedure applies only when it appears that "there is no controlling precedent in the decisions of the supreme court of this state." In *Lehman Brothers*, *supra*, the court of appeals specifically determined that Florida law, which was controlling was not "decisive." 416 U.S. at 389. This Court couched its discussion of the duty to certify in terms of "doubt as to local law."

In this case, North Dakota law is not particularly doubtful, but is instead relatively clear. *West*, a "proceeds" case, is inapplicable to a "market value at the well" case. *Amerada Hess* involved the determination of "gross value at the well" for purposes of gross production taxes, rather than the "market value at the well" for purposes of royalty, and so is not "controlling." However, the North Dakota court in *Amerada Hess* noted that "gross value at the well" meant "fair market value of the gas" (410 N.W. 2d at 128), and further noted that the same general interpretation rules govern both the interpretation of statutes and contracts such as oil and gas leases. 410 N.W. 2d at 130, n. 6. The North Dakota Court more recently reaffirmed the holding of *Amerada Hess* in *Koch Oil Co. v. Hanson*, 536 N.W. 2d 702 (N.D. 1995). Under *Piney Woods*, as relied upon by the court in *Amerada Hess*, there is no doubt but that the expenses of processing, transportation and marketing may be deducted in determining the value of gas "at the well." *See Piney Woods*, 726 F.2d at 240.

Second, the petitioners at no time requested either the district court or the court of appeals to certify any question to the North Dakota Supreme Court. As noted above, Rule 47 of the North Dakota Rules of Appellate Procedure specifically provides that the rule may be invoked either upon the court's own motion or upon the motion of any party to the cause. Petitioners

apparently made a strategic decision not to seek certification of a question, but instead to rely upon their less than well-founded argument that *West v. Alpar* controlled this case.

III.

IN ANY EVENT, PETITIONERS HAVE NOT ESTABLISHED, AND THERE DO NOT EXIST, ANY "COMPELLING REASONS" FOR GRANTING CERTIORARI IN THIS CASE.

Under Rule 10 of the Supreme Court Rules, a petition for writ of certiorari "will be granted only for compelling reasons." Rule 10 specifically includes three examples of the character of the reasons the court considers in reviewing petitions for certiorari:

> (1) a conflict between the decisions of two courts of appeals on an important matter, or a conflict between the decision of a court of appeals and a state court of last resort on an important federal question, or a departure by a court of appeals such as calls for an exercise of the supreme court supervisory power;
>
> (2) a decision by a state court of last resort on an important federal question that conflicts with another controlling state court decision or a decision of a court of appeals;
>
> (3) a decision by a state court or court of appeals on an important question of federal law that has not been decided by the supreme court or in such a fashion that conflicts with the relevant decision of the supreme court.

Prior to the revision of the Supreme Court Rules in 1980,

Rule 19(1)(b) included as a specific consideration for granting review on certiorari, a court of appeals' decision that resolved "an important state or territorial question in a way in conflict with applicable state or territorial law."

This case does not involve any questions of federal law, nor does it involve any question as to whether federal or state law should apply. This case involves purely the application of state law to a contract dispute.

The expertise of the courts of appeals as to matters of local law of the states within their circuits has previously been recognized. *See Butner v. United States*, 440 U.S. 48, 57-58 (1979); and *Brockett v. Spokane Arcades, Inc.*, 472 U.S. 491, 499-500 (1985).

> [O]rdinarily we accept and therefore do not review, save in exceptional cases, the considered determination of questions of state law by the intermediate federal appellate courts.

Huddleston v. Dwyer, 322 U.S. 232, 237 (1944).

CONCLUSION

Because the courts below correctly applied North Dakota law to this contract dispute, and because, in any event, there are no "compelling reasons" for granting the writ of certiorari, the petition should be denied.

Respectfully submitted,

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